FOR ARGUMENT

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,
Respondents.

On Writ of Certiorari To the United States Court of Appeals For The Fifth Circuit

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BRIEF OF RESPONDENT STATE OF LOUISIANA

HONORABLE EDWIN W. EDWARDS
Governor, State of Louisiana

HONORABLE WILLIAM J. GUSTE, JR.
Attorney General, State of Louisiana

HONORABLE WILLIAM C. HULS
Secretary, Department of Natural Resources, State of Louisiana

HONORABLE RAY T. SUTTON
Commissioner of Conservation, State of Louisiana

JAMES R. PATTON, JR.
DAVID B. ROBINSON
LINDA E. BUCK
TIMOTHY N. SEWARD
PATTON, BOGGS & BLOW
1200 Seventeenth St., N.W.
Washington, D.C. 20036

HARRY E. BARSH, JR.
CAMP, CARMOUCHE, PALMER, BARSH & HUNTER
1200 Seventeenth St., N.W.
Washington, D.C. 20036

Counsel for the State of Louisiana

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OPINIONS BELOW AND JURISDICTION

Louisiana adopts the references to the opinions below and the statement of jurisdiction set forth in the brief of the Federal Energy Regulatory Commission (Commission).

QUESTION PRESENTED

Whether the Commission has legal authority under the Natural Gas Act to consider the request of a natural gas company to recover in its rates a royalty cost which was computed as a percentage of the "market value"

of the gas which the natural gas company produced and sold.

STATUTES INVOLVED

The Commission's brief correctly cites the statutes involved.

STATEMENT

In the interest of brevity, Louisiana will not recount the procedural history of this proceeding, an undertaking which has been performed by other parties. The central issue in this case is simply one of jurisdiction—does the Federal Energy Regulatory Commission (FERC) have the legal authority to consider the request of a natural gas producer to recover the cost of "market value" royalty payments incurred under its lease.[1] Since that issue has, in fact, already been decided by this Court,[2] and because it has been fully briefed by other parties, Louisiana will not burden the Court with detailed argument on the jurisdictional issue. Rather, Louisiana, as a state which regulates the activities of natural gas producers within its borders, is making this submission primarily (1) to supplement the briefs of the other respondents and (2) to attempt to illuminate for the Court the nature of the lease relationship between a landowner and a producer and the reasons why that relationship is unaffected by the Natural Gas Act.

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[1] The other issue in this case is whether the Commission should have considered the producers' abandonment application on its merits. Louisiana agrees with other Respondents (Shell Oil Company, Pennzoil Producing Company and United Gas Pipe Line Company) that the abandonment application should have been considered and adopts the arguments of those parties on the "abandonment" issue.

[2] Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974).

SUMMARY OF ARGUMENT

A. A lease agreement between a producer and a landowner is a contractual arrangement governed by state law and is unaffected by the Natural Gas Act.

The royalty which the landowner bargains for is a cash payment given to him in exchange for the right to explore for natural gas, to extract it from the land, and to construct and operate production facilities. Unless the lease specifically gives the landowner the right to take a portion of his royalty in kind, and the landowner exercises that right, there is no gas "attributable to the royalty share." The formula by which the payment is computed is a matter to be determined by negotiation between the producer and the landowner.

The Commission has no jurisdiction to regulate landowners or royalty payments. *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256 (D.C. Cir. 1972) *cert. denied*, 406 U.S. 976 (1972). The Commission's lack of jurisdiction flows from the carefully expressed intention of the Congress to leave with the states the responsibility for regulating all areas of natural gas production and distribution except for those matters which the states were barred from regulating by the Commerce Clause of the U.S. Constitution. *Federal Power Commission* v. *Panhandle Eastern Pipe Line Company*, 337 U.S. 507 (1947). The Commission, however, retains authority to protect consumers against unreasonable lease costs by denying recovery of costs which it finds to be imprudent.

B. A cost-based rate must permit natural gas companies to recover reasonably incurred costs. The Commission therefore has the authority and the responsibility to consider whether the costs incurred by the

producers in this case were prudent and reasonable. *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283 (1974).

ARGUMENT

A. A LEASE AGREEMENT BETWEEN A PRODUCER AND A LANDOWNER IS A CONTRACTURAL ARRANGEMENT GOVERNED BY STATE LAW AND IS UNAFFECTED BY THE NATURAL GAS ACT. IN DETERMINING WHETHER TO ALLOW PRODUCERS TO RECOVER THEIR ROYALTY COSTS, HOWEVER, FERC CAN REVIEW THOSE COSTS TO DETERMINE WHETHER THEY WERE REASONABLY INCURRED.

1. The Nature of the Relationship Between Landowner and Producer.

A landowner is not a producer or seller of natural gas. The Commission's persistent characterization of certain gas as "attributable to the royalty interest" (Commission Brief at, *e.g.*, 6, 7) is extremely misleading. The royalty paid to a landowner by a producer is a bargained-for cash consideration. The royalty payment is given to the landowner in exchange for the right he grants to the producer to explore for and produce natural gas from his property and for permitting the construction and operation of wells, pipes, and other facilities on his land. Typically, the producer owns all of the gas produced under the lease.[3]

The amount of the royalty is fixed contractually by the free bargain and exchange between the landowner and the producer, subject to whatever requirements

[3] Some leases allow the landowner to elect to take a portion of the gas in kind in lieu of receiving a cash payment. If that election were made, the landowner would then own his share of the gas, but if the election were not made, the landowner would own none of the gas.

might be imposed upon the relationship by state law. In the present case, the royalty was set at a fraction of the "market value" of the gas; it could just as easily have been set at a fixed dollar amount or according to some other formula.

2. The Effect of the Natural Gas Act on the Lease Relationship.

The royalty obligation is thus but one of a producer's many costs of production. As will be shown below, the Natural Gas Act gives the FERC no more control—direct or indirect—over lease costs than it has over the costs of labor or drilling equipment. Yet FERC suggests in its brief to this Court that the Commission need not even entertain the question of whether a royalty cost is reasonable because this Court might determine—in another case[4]—that the Natural Gas Act somehow preempts the state law of real property and compels the finding that a reference to "market value" must be construed as referring to the regulated rate. (FERC Brief at 27 n. 22). Similarly, Mobil Oil Company has even suggested that this Court defer decision in this case until it has decided whether to reconsider its decision to deny certiorari in *Lightcap*. Both FERC and Mobil, however, by suggesting that the Natural Gas Act could govern the interpretation of a mineral lease, ignore (1) the legislative history of the Natural Gas Act and (2) the clearly expressed intent of the Congress not to regulate lease transactions between producers and landowners. The meaning of disputed royalty provisions in oil and gas leases has always governed by state law, and Congress did not intend to disturb or

[4] Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1 (1977) *cert. denied*, Mobil Oil Corp. v. Lightcap, 434 U.S. 476, *Petition for Rehearing Pending*, Case No. 76-1694.

"preempt" the traditional role of the state courts in interpreting natural gas leases under state law.

As the Commission acknowledges in its brief to this Court (at 37 n. 22) and in the orders under review (A. 260), the Commission has no jurisdiction to regulate landowners or royalty payments. *Mobil Oil Corp.* v. *Federal Power Commission,* 463 F.2d 256 (D.C. Cir. 1972) *cert. denied,* 406 U.S. 976 (1972).

The D.C. Circuit, in *Mobil,* based its holding that the Commission lacked jurisdiction over royalty payments to landowners on the plain language of the Natural Gas Act. Section 1(b) of the Act limits the Commission's jurisdiction to:

> . . . [T]he transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption, for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale. . . . 15 U.S.C. § 717b.

The D.C. Circuit found that landowners, when they give natural gas companies a leasehold right to explore for and extract natural gas from their lands, are not engaged in the "sale in interstate commerce of natural gas for resale." The FPC had advanced to the Court various "policy" justifications for its attempt to assert jurisdiction over landowners. The Court rejected them, finding that the "policy" arguments were:

> not sufficient justification upon which to base an expansion of the Act to activities clearly not within its terms. Congress did not give the FPC carte blanche to take whatever action it might consider appropriate in furtherance of this purpose. The FPC is limited by the provision establishing its jurisdiction. 463 F.2d 256, 263.

The exclusion of landowners from the regulatory jurisdiction of the Commission was not accidental. It followed necessarily from the carefully defined Congressional plan to give the Commission only those limited powers necessary to enable it to exercise authority over those interstate transactions which this Court had previously held were beyond the powers of the states to regulate.[5] The purpose of the Act was to create federal regulation only where necessary to fill the "gap" where the states were powerless to act because of the commerce clause of the U.S. Constitution. The drafters of the Act deliberately sought to avoid extending federal regulation to those areas which the states constitutionally could regulate:

> . . . . [*T*]*he Natural Gas Act did not envisage federal regulation of the entire natural gas field to the limit of Constitutional power.* Rather, it contemplated the exercise of federal power as specified in the Act, particularly in that interstate segment which the states were powerless to regulate because of the Commerce Clause of the Federal Constitution. *The jurisdiction of the Federal Power Commission was to complement that of the state regulatory bodies.* Accordingly, Congress in § 1(b) of the Act not only prescribed the intended reach of the Commission's power, but also specified the areas into which this power was not to extend. *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.,* 337 U.S. 498, 502-3 (1949) (footnote omitted, emphasis supplied).

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[5] See the discussion of the Court in Panhandle Eastern Pipe Line Co. v. Public Service Commission, 332 U.S. 507 (1947) at 514-19.

And:

> The Act, though extending federal regulation, had no purpose or effect to cut down state power. On the contrary, perhaps its primary purpose was to aid in making state regulation effective, by adding the weight of federal regulation to supplement it and reenforce it in the gap created by the prior decisions. *The Act was drawn with meticulous regard for the continued exercise of state power, not to handicap it or dilute it in any way. Panhandle Eastern Pipe Line Co.* v. *Public Service Commission,* 332 U.S. 507, 517-518 (1947) (footnotes omitted, emphasis supplied).

This Court has emphasized that those areas which the states were constitutionally capable of regulating before the Natural Gas Act was passed were left to be governed by the states and were not touched by the Natural Gas Act:

> The legislative history of the Act is replete with evidence of the care taken by Congress to keep the power over the production and gathering of gas within the states. . . . The Natural Gas Act was designed to supplement state power and to produce harmonious and comprehensive regulation of the industry. *Neither state nor federal regulatory body was to encroach upon the jurisdiction of the other. Federal Power Commission* v. *Panhandle Eastern Pipe Line Company, supra,* 337 U.S. 507, 509-13 (footnotes omitted, emphasis supplied).

Since the Natural Gas Act purposefully preserved to the states the rights which they could exercise when the Act was passed, the traditional role of the states in regulating the relationship between landowners and producers was left undisturbed. The drafters of the Natural Gas Act certainly could have had no intent to "preempt" state law on the interpretation of royalty agreements. The interpretation of a royalty clause re-

mains a matter of state law to be decided by the state courts.

3. Commission Review of Royalty Costs.

The fact that the Commission has no regulatory jurisdiction over landowners or royalty payments does not, by any means, mean that the Commission is powerless to protect the consumer against lease costs which have been imprudently entered into. The Commission's control over lease costs is indirect. In that respect, it is no different from its control over other costs of production. Just as the FERC can deny the recovery of the cost of "platinum pipe" (FERC Brief at 18), it can deny recovery of a royalty cost which it finds to be imprudent. The rule was well stated by the D.C. Circuit in *Mobil:*

> . . . [T]he FPC's jurisdiction over rates chargeable by a producer includes authority to determine the reasonableness of costs incurred, even though these are not subject to direct FPC control, and that establishes authority to review royalty payments, or drilling rig rentals, or any other element of the producer's cost of service. 463 F.2d 256, 263 (footnote omitted).

B. THE COMMISSION HAS AUTHORITY TO PERMIT PRODUCERS TO RECOVER THE COSTS OF PRUDENTLY INCURRED ROYALTY OBLIGATIONS.

As explained more fully in the briefs of Shell Oil Company, Pennzoil Producing Company and United Gas Pipe Line Company, cost-based rates must of course be constructed so as to permit gas companies to recover reasonably incurred costs. The D.C. Circuit has stated the principle this way:

> Expenses. . . . are facts. They are to be ascertained, not created, by the regulatory authorities. *If prop-*

erly incurred, they must be allowed, as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment being an amount over and above expenses, would be a farce. *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 163 F.2d 433, 437 (D.C. Cir. 1947) (emphasis supplied).

The proper inquiry is thus not what a cost is "based on" but, rather, whether the cost incurred was prudent and reasonable when incurred. Just four years ago, in *Mobil Oil Corp.* v. *Federal Power Commission,* 417 U.S. 283 (1974), this Court confirmed as clearly as possible the obvious proposition that the Commission has authority to allow producers to recover the costs of royalties like those at issue in this case. The Commission has unaccountably chosen to ignore this Court's instructions to it.

In *Mobil,* the Fifth Circuit below had sustained the Commission's determination that area rates should not be adjusted simply because royalty costs might rise in the future.[6] In so holding, however, the Fifth Circuit took as a given the proposition that any significantly increased royalty costs which were actually incurred by the producer could be a proper component of the rate structure:

> Of course the royalty obligations of the producers are cost components of the rate structure. *Any alteration of this component would necessarily alter the departure point of the rate calculations.* 483 F.2d 880, 911 (emphasis supplied).

Following logically from that principle, the Fifth Circuit found two corollary propositions: (a) that pro-

[6] The decision below was reported as Placid Oil Co. v. Federal Power Commission, 483 F.2d 880 (Fifth Cir. 1973).

ducers who actually incurred increased royalty obligations could petition the Commission for individualized relief, and (b) that if conditions changed on an industry-wide basis in the future, changes in the ceiling rates themselves could be appropriate:

> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may *certainly* petition FPC for individualized relief. Permian contemplated it. FPC has on occasion given it . . . and we find it to be far preferable to the speculative prophecy of future royalty components. If the royalty obligations are such as to make the rates established by Op. 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will *certainly* have recourse to the administrative process. And . . . if FPC determines that future events substantially change the rate structure for the industry as a whole, it may make appropriate changes. 483 F.2d 880, 911 (emphasis supplied).

Affirming, the Court quoted with approval the relevant portions of the Court of Appeals decision and stated that "in any event an affected producer is entitled to seek individualized relief." 417 U.S. 283, 328.

Yet the Commission now seeks to claim that it lacks jurisdiction even to consider the relief which this Court told the producers they were "entitled to seek." The Commission's argument is absurd.

The Commission has attempted to find support for its position in a strained interpretation of this Court's decision in *FPC* v. *Texaco,* 417 U.S. 380 (1974). But *Texaco* dealt with a very different issue. *Texaco* held only that *prices* received by producers for natural gas may not be determined solely by the price the gas would bring in a free market. It decidedly did not hold

or even imply that a producer may not recover reasonably incurred *costs* which are, by contract prudently entered into, fixed at a percentage of the market price.

CONCLUSION

The decision of the Court of Appeals below is correct under this Court's prior decision in *Mobil* and under well-established rate making principles. The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

James R. Patton, Jr.
David B. Robinson
Linda E. Buck
Timothy N. Seward
Patton, Boggs & Blow
1200 Seventeenth St., N.W.
Washington, D.C. 20036

Harry E. Barsh, Jr.
Camp, Carmouche, Palmer,
Barsh & Hunter
1200 Seventeenth St., N.W.
Washington, D.C. 20036

Counsel for the State of Louisiana

Honorable Edwin W. Edwards
Governor, State of Louisiana

Honorable William J. Guste, Jr.
Attorney General, State of Louisiana

Honorable William C. Huls
Secretary, Department of Natural Resources, State of Louisiana

Honorable Ray T. Sutton
Commissioner of Conservation, State of Louisiana

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